STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	**)**	
Proposed General Increase in	**)**	**Docket No. 07-0241**
Rates for Gas Service	**)**	
	)	
THE PEOPLES GAS LIGHT AND COKE COMPANY	**)**	
Proposed general increase in	**)**	**Docket No. 07-0242**
Rates for Gas Service	**)**	

DIRECT TESTIMONY OF DAVID J. EFFRON ON BEHALF OF THE PEOPLE OF THE STATE OF ILLINOIS THE CITY OF CHICAGO AND THE CITIZENS UTILITY BOARD

GCI Exhibit 2.0

JULY 3, 2007

NORTH SHORE GAS COMPANY
THE PEOPLES GAS LIGHT AND COKE COMPANY
DOCKET NOS. 07-0241, 07-0242
TESTIMONY OF DAVID J. EFFRON
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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My address is 12 Pond Path, North Hampton, New Hampshire, 03862.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty-five years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings and other utility matters?

A. I have analyzed numerous electric, gas, telephone, and water filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in over two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and Washington.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University

II. INTRODUCTION AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the People of the State of Illinois ("AG") , the Citizens Utility Board ("CUB") and the City of Chicago ("City") (collectively "Governmental and Consumer Intervenors" or "GCI") in response to the Peoples Gas Light and Coke Company ("PGL") rate filing. I am testifying on behalf of the AG and CUB in response to the North Shore Gas Company ("NS") rate filing.

Q. What is the purpose of your testimony?

A. I am recommending rate base and pro forma operating income for NS and PGL (together "the Companies") in these rate cases, based on the adjustments to the Companies' positions that I have identified in my review and analysis of the Companies' presentations. I have also incorporated the rate of return recommended by Mr. Thomas into my calculation of the Companies' revenue deficiency (or excess) under present rates.

Q. How is your testimony organized?

A. My testimony is divided into three sections. Section A summarizes my calculation of the Companies' revenue deficiency or excess. Section B addresses my proposed adjustments to the Companies' test year rate base and is supported by schedules prefixed with "B". Section C addresses my proposed adjustments to the Companies' test year operating income and is supported by schedules prefixed with "C".

III. REVENUE REQUIREMENT ISSUES

A. SUMMARY

Q. What revenue deficiency or excess have you calculated for NS and PGL?

A. With regard to NS, based on the test year consisting of the 12 months ended September 30, 2006 I have calculated a rate base of $185,084,000 and pro forma operating income under present rates of $14,405,000. Based on the overall rate of return of 6.93% recommended by Mr. Thomas, NS presently has an operating income excess of $1,586,000. With a revenue conversion factor of 1.6713, that income excess translates into a revenue excess of $2,650,000 under present rates. The calculation of this revenue excess is summarized on my Schedule A.

With regard to PGL, based on the test year consisting of the 12 months ended September 30, 2006 I have calculated a rate base of $1,200,986,000 and pro forma operating income under present rates of $56,248,000. Based on the overall rate of return of 6.60% recommended by Mr. Thomas, PGL presently has an operating income deficiency of $23,029,000. With a revenue conversion factor of 1.7029, that income deficiency translates into a revenue deficiency of $39,215,000 under present rates. The calculation of this revenue deficiency is summarized on my Schedule A.

As the GCI parties are opposing the Companies' proposal to recover uncollectible accounts expense related to gas charge revenue through a separate rider, I have included the full amount of my adjusted pro forma test year uncollectible accounts expenses in the Companies' base rate revenue requirements.

The above calculated base rate revenue deficiency (excess) assumes that the full amounts of my proposed pro forma uncollectible accounts expense is recovered in base rates.

B. RATE BASE

1. PLANT IN SERVICE

Q. Are the Companies proposing to adjust their rate bases for post-test year additions to plant in service?

A. Yes. Both NS and PGL are proposing adjustments to rate base to recognize plant additions through September 30, 2007, one year after the end of the test year. These adjustments increase plant in service by $10,645,000 (NS) and $104,524,000 (PGL). In conjunction with these adjustments, the Companies have also recognized increases in the balances of accumulated depreciations of $442,000 (NS) and $2,387,000 (PGL) and increases in the balances of accumulated deferred income taxes of $304,000 (NS) and $6,673,000 (PGL). Both the increases to the balances of accumulated depreciation and accumulated deferred income taxes are directly associated with the proposed post-test year additions to plant. The adjustments being proposed by the Companies increase their test year rate bases by $9,899,000 (NS) and $95,464,000 (PGL). In addition, the depreciation expense on the additions to plant in service increases pro forma test year jurisdictional expenses by $442,000 (NS) and $2,387,000 (PGL).

Q. Have the Companies properly quantified the effect of their proposed rate base adjustments to recognize post-test year additions to plant?

A. No. The Companies' proposed adjustments are selective and one-sided, in that they do not recognize other changes that will be taking place after the end of the test year - changes that will tend to offset the revenue requirement effects of the additions to plant in service. In particular, although the Companies recognize the increase in accumulated depreciation directly related to the forecasted plant additions, they do not recognize the growth in accumulated depreciation on embedded plant in service that will be taking place as the new plant additions are going into service. In addition, the forecasts of additions overstate the level of additions that are likely to take place in the twelve months ending September 30, 2007.

Q. Will growth in the accumulated reserve for depreciation on embedded plant in service provide a significant offset to the revenue requirement effect of the post-test year additions to plant?

A. Yes. As noted above, PGL is proposing to include additions to plant in service out to September 30, 2007 in its pro forma rate base. In the twelve months ended September 30, 2006, PGL recorded $48,664,000 of depreciation and amortization expense on its jurisdictional plant in service. Thus, from September 30, 2006 to September 30, 2007 (the period covered by the proposed additions to plant) the balance of accumulated depreciation and amortization can be expected to increase by over $48 million as a result of recording depreciation expense on plant that was in service during the test year. Because the accumulated reserve for depreciation is deducted from plant in service in the determination of rate base, this increase in the depreciation reserve will reduce rate base by over $48 million. While the amounts are proportionally smaller for NS, the principle is the same – the growth in the accumulated reserve for depreciation will provide a substantial offset to the growth in rate base resulting from plant additions.

Q. Can you further illustrate the selective nature of the rate base adjustments being proposed by the Companies?

A. Yes. The test year in Docket No. 95-0032 (PGL) was the twelve months ended September 30, 1996. In that case, the plant in service net of accumulated depreciation and plant related deferred taxes included in the Commission approved rate base was $999 million. As of September 30, 2006, the end of the test year in this case, the PGL actual plant in service net of accumulated depreciation and plant related deferred taxes included in rate base was $1.094 billion before any adjustments. Thus, the increase in plant net of depreciation and deferred taxes in this ten year period was approximately $95 million. This means that PGL is proposing an adjustment to rate base for post-test year additions to plant in the *one year* after the end of the test year in this case that is approximately equal to the increase in net plant in the *ten years* ended September 30, 2006. Based on this comparison, the rate base adjustment proposed by PGL is clearly unreasonable.

As the future additions take place and increase the balance of gross plant, the accumulated reserve for depreciation will also continue to grow as a result of recording depreciation expense on total plant in service. Thus, the net plant in service included in rate base will not increase by an amount equal to future additions. When growth in the balance of the accumulated reserve for depreciation is taken into account, the effect of growth in rate base due to plant additions will be mitigated significantly. This highlights the selective nature of the Companies' proposed adjustments to recognize the effect on rate base of post-test year additions to plant in service. It makes little sense to allow a selective pro forma adjustment to increase rate base for post-test year plant additions when the Company's actual growth in the net plant in service, and its rate base, will be substantially less.

Q. If the Commission allows the Companies to adjust its rate base for post-test year additions to plant in service, should the Companies' adjustments be modified?

A. Yes. At a minimum, there should be at least two modifications to the pro forma adjustments being proposed by the Companies.

First, if rate base is to be adjusted for post-test year additions to plant, then the effect of the growth in the balance of the accumulated reserve for depreciation should also be taken into account. I address such an adjustment in the next section of this testimony. Second, the forecasts of additions to plant should be modified so that the adjustments are more consistent with the likely additions to plant in fiscal year 2007.

Q. How do the Companies' forecasts of plant additions compare to the actual additions to plant in recent years?

A. The PGL adjustment to rate base reflects forecasted plant additions of $104.5 million in the twelve months ending September 30, 2007. In the five years ended September 30, 2006 the average of annual plant additions was approximately $74.4 million. The highest level of plant additions in any of those five years was $86.9 million. The forecast of $104.5 million for fiscal 2007 is clearly out of line with this historical experience.

The NS adjustment to rate base reflects forecasted plant additions of $10.6 million in the twelve months ending September 30, 2007. This forecast is also somewhat greater than the actual average of plant additions in recent years, although this forecast is not as clearly out of line as the PGL forecast of plant additions.

Q. What do you recommend?

A. In responses to AG Data Requests 8.06 (NS) and 8.13 (PGL), the Companies provided updated forecasts of plant additions for the twelve months ending September 30, 2007. The updated NS spending forecast for the twelve months ending September 30, 2007 is $10,116,000. The updated PGL spending forecast for the twelve months ending September 30, 2007 is $86,006,000. These updated forecasts of plant additions are more in line with the Companies' actual plant additions in recent years and more in line with the actual rate of post-test year plant additions through April 2007. I recommend that the forecast of plant additions be modified based on the updates provided by the Companies. Making these updates to the forecasts of plant additions reduces the NS forecast of plant additions by $529,000 and the PGL forecast of plant additions by $18,518,000 (my Schedule B-1).

2. RESERVE FOR ACCUMULATED DEPRECIATION

Q. Are you proposing any adjustments to the reserve for accumulated depreciation?

A. Yes. As I stated above, I am proposing to modify the Companies' proposed adjustments to the accumulated reserve for depreciation so that they are consistent with their proposed adjustments to rate base for post-test year additions to plant in service. The Companies' proposed adjustments to rate base take into account plant additions through September 30, 2007. To be consistent, the adjustments to accumulated reserve for depreciation should also take account of the increase in that balance through September 30, 2007. Further, the adjustments should not be limited to the incremental depreciation on plant additions, but should also recognize the growth in the accumulated reserve for depreciation on plant in service as of the end of the test year as well.

Q. How do you propose to adjust the accumulated reserve for depreciation so that the pro forma balances are stated in a manner consistent with the pro forma plant in service included in rate base?

A. Before any adjustments, the accumulated reserve for depreciation reflects the balance as of the end of the test year, September 30, 2006. The Companies are proposing to recognize post-test year additions to plant through September 30, 2007, one year after the end of the test year. Consistent with these adjustments, the accumulated reserve for depreciation on plant in service should be adjusted to reflect an additional year of depreciation expense. Based on the actual depreciation recorded in twelve months ended September 30, 2006 plus the depreciation on the fiscal 2007 plant additions, I have calculated that the additional fiscal 2007 depreciation expense will increase the pro forma NS balance of accumulated depreciation and amortization reserve by $5,702,000 and the pro forma PGL balance of accumulated depreciation and amortization reserve by $48,241,000 over the increases in the depreciation reserve recognized by the Companies (my Schedule B-1).

One other adjustment to the pro forma balance of accumulated depreciation and amortization reserve is necessary. As plant is retired, the Companies will incur cost of removal on those retirements and charge that cost against the accumulated depreciation reserve. Annualizing the actual cost of removal incurred through March 2007, I have estimated the net cost of removal on NS plant retirements to be $182,000 and the net cost of removal on PGL plant retirements to be $3,694,000 (my Schedule B-1).

Q. What net adjustments to the Companies' pro forma balances of accumulated depreciation and amortization reserve are you proposing?

A. I am proposing an adjustment to the NS pro forma balance of accumulated depreciation and amortization reserve of $5,520,000 and the PGL pro forma balance of accumulated depreciation and amortization reserve of $44,547,000 (my Schedule B-1).

3. ACCRUED LIABILITY FOR POSTRETIREMENT BENEFITS

Q. Do NS and PGL have accrued liabilities for postretirement benefits other than pensions ("OPEB")?

A. Yes. The Companies accrue liabilities for OPEB pursuant to Statement of Financial Accounting Standards 106 ("FAS 106"). To the extent that the cumulative accruals are greater than the actual cash disbursements for the postretirement benefits, the Companies will have accrued liabilities for OPEB. Thus, the accrued liabilities represent the expenses accrued in excess of actual payments for OPEB. As of September 30, 2006, the end of the test year in these cases, the accrued liability for OPEB was $7,094,000 for NS and $55,653,000 for PGL (NS response to AG Data Request 5.15 and PGL response to AG Data Request 5.01).

Q. Have the Companies taken the balances of accrued OPEB expense into account in the determination of their rate bases?

A. No. Neither NS nor PGL has recognized the accrued OPEB liability in the calculation of its rate base.

Q. What is your understanding of the Commission's usual practice with regard to the treatment of accrued liabilities for OPEB in the determination of rate base?

A. In Docket No. 95-0219 (Northern Illinois Gas Company), the Commission found that as long as the Company continues to control the ratepayer-supplied OPEB funds, the OPEB deduction should be recognized in the determination of rate base (Order, page 10). In that company's next base rate case, Docket No. 04-0779, the Commission deducted $97,393,000 of "Retirement Benefits, Net", comprised of the accrued OPEB liability, from plant in service in the determination of rate base. In Docket Nos. 06-0070, 06-0071, and 06-0072, Consolidated (AmerenCILCO, AmerenCIPS, AmerenIP), the Commission found that the accrued OPEB liability should be removed from rate base (Order, page 27). Based on the Commission's findings in those cases, it is my understanding that it is the Commission's usual practice to deduct the accrued OPEB liability from plant in service in the determination of rate base.

Q. Have you deducted the accrued OPEB liabilities from plant in service in your determination of the Companies' rate bases?

A. Yes. I have reflected a rate base deduction of $7,094,000 for the NS accrued OPEB liability and a rate base deduction of $55,653,000 for the PGL accrued OPEB liability (my Schedule B).

4. ACCUMULATED DEFERED INCOME TAXES

Q. Are you proposing any adjustments to the balance of accumulated deferred income taxes ("ADIT") deducted from plant in service in the determination of rate base?

A. Yes. ADIT represents the cumulative effect of book-tax timing differences, such as the deferred tax liability associated with the excess of tax accelerated depreciation over book depreciation.

Consistent with my proposed adjustments to post-test year plant additions, service, I am also modifying the related adjustment to ADIT. This adjustment is shown on my Schedule B-2 and reflects the reduction to the balance of ADIT associated with my proposed reductions to post-test year plan additions. I have also adjusted the accumulated deferred income tax balance to include the deferred taxes on the OPEB liabilities in association with my proposed rate base deductions for the accrued OPEB liabilities. This adjustment to ADIT is also on my Schedule B-2.

In addition to these derivative adjustments to the balances of ADIT, I am proposing two other adjustments to the balances of accumulated deferred income taxes. First, I am proposing to modify the Alternative Minimum Tax ("AMT") balances. Second, I am proposing to eliminate the state and federal deferred income tax balances on the Gas Cost Reconciliation as of September 30, 2006.

Q. Why are you proposing to modify the AMT balances included in the total of accumulated deferred income taxes?

A. The revenue requirement presentations by the Companies remove the effect of the gas charge settlements approved by the Commission in ICC Docket Nos. 00-0719, 00-0720, 01-0706, 01-0707, 02-0726, 02-0727, 03-0704, 03-0705, 04-0682, and 04-0683, from the cost of service. NS and PGL pro forma adjustments No. 11 eliminate the cost of the gas charge settlement itself from pro forma test year operating expenses. The Companies also eliminate what can be described as secondary effects of the gas settlement charges on test year expenses. For example, the collection agency fees were reduced in fiscal year 2006 because of the gas charge settlements. NS and PGL pro forma adjustments 19 increased the collection agency fees to what the Companies considered to be the normal level of fees that would have been incurred in the absence of the gas charge settlement (NS response to AG Data Request 2.29 and PGL response to AG Data Request 2.32)

The AMT balances represent the cumulative AMT paid by the Companies. Because actual AMT payments can be used to offset future income tax liabilities, the AMT payments are treated as deferred charges rather than as current expenses. The gas charge settlement affected the Companies' taxable income and the income subject to the AMT. In its response to AG Data Request AG 2.10, NS stated that the incremental AMT booked in 2006 was $1,586,000, but in the absence of the expense of the gas charge settlement, the AMT in 2006 would have been $813,000. In other words, except for the gas charge settlement, the cumulative AMT balances as of September 30, 2006 would have been lower by $773,000. If it is appropriate to eliminate the effect of the gas charge settlement on the NS test year revenue requirement, then the AMT balance included in rate base should be adjusted to exclude the effect of the gas charge settlement expense booked in the test year. Making this adjustment increases the accumulated deferred income taxes deducted from the NS rate base by $773,000 (my Schedule B-2).

Similarly, in its response to AG Data Request AG 2.11, PGL stated that the incremental AMT booked in 2006 was $16,040,000, but in the absence of the expense of the gas charge settlement, the AMT in 2006 would have been $8,220,000. Thus, except for the gas charge settlement, the cumulative AMT balance as of September 30, 2006 would have been lower by $7,820,000. Making this adjustment to the cumulative AMT balance increases the accumulated deferred income taxes deducted from the PGL rate base by $7,820,000 (my Schedule B-2).

Q. Why are you proposing to eliminate the state and federal deferred income tax balances on the Gas Cost Reconciliation?

A. For two reasons. First, these state and federal deferred income taxes are debit balances that relate to the accrued liabilities for the Gas Cost Reconciliation as of September 30, 2006. These accrued liabilities are not themselves deducted from rate base. As the accrued liabilities that give rise to these deferred tax debit balances are not deducted from rate base, the related deferred tax balances should be treated consistently and should also excluded from the determination of rate base.

Second, there is no reason to believe that the deferred tax debit balances that happened to exist as of September 30, 2006 are representative of the deferred tax balances that normally exist. These deferred tax debit balances arise from the accrued liability for over-recovered gas costs. Unless there is some reason to believe that the Company systematically overestimates its cost of purchased gas so that there will always be an over-recovered balance, the deferred tax debit balance related to the liability for the over-recovery cannot be deemed to be a normal condition. There might be times when there is an over-recovery and times when there is an under-recovery, but over time the recovery of gas costs should balance out so that on average the balance will be zero, and the related deferred tax balance will also be zero. In fact, for both Companies, as of the beginning of the test year, the accumulated deferred income tax balances on the Gas Cost Reconciliation were credits, supporting the theoretical principle that this deferred tax balance is just as likely to be a credit balance as a debit balance.

Q. What is the effect of eliminating the state and federal deferred income tax balances on the Gas Cost Reconciliation?

A. The effect is to increase the net rate base deduction for accumulated deferred income taxes deducted from the NS rate base by $1,142,000 and to increase the net rate base deduction for accumulated deferred income taxes deducted from the PGL rate base by $5,748,000 (my Schedule B-2).

C. OPERATING INCOME

1. REVENUE

Q. How did the Companies determine pro forma test year operating revenues under present rates?

A. The Companies determined pro forma base rate revenues by applying the presently authorized rates to test year billing determinants adjusted to reflect normal weather conditions. The pro forma gas charge revenues represent the test year booked gas charge revenues adjusted for normal weather.

Q. Are you proposing any adjustments to the test year revenues reflected by NS and PGL in the determination of pro forma operating income under present rates?

A. Yes. I am proposing to adjust the gas charge revenues included in total pro forma test year revenues under present rates. In determining pro forma test year operating income, the gas charge revenues match the cost of gas expenses. Thus, any adjustment to the gas charge revenue is matched by an equal and offsetting adjustment to the cost of gas expense. However, the pro forma uncollectible accounts expense is based on a percentage of total operating revenues including gas charge revenues. Therefore, an adjustment to gas charge revenues has an effect on pro forma operating income because the uncollectible accounts expense varies directly with the revenues recorded.

Q. Why are you proposing to adjust pro forma gas charge revenues?

A. As can be seen on Exhibit LTB-1.1, the price of gas in the test year reached a peak that far exceeded the prices in any other year on chart, which goes back to 1994. There have been spikes in the price of gas in other recent years, notably 2001, but nothing to match the peak price reached in the twelve months ended September 30,

2006. Since the peak in price reached during that twelve month period, the price of gas has receded to a level that, while still high by historical standards, is less than the average price for the twelve months ended September 30, 2006, which was affected by the unusual spike in the price of gas in the winter of 2005-06. For PGL, the average test year gas cost revenue for sales customers was approximately $10.00 per dekatherm (PGL Schedule E-5) and for NS, the average test year gas cost revenue for sales customers was approximately $9.80 per dekatherm (NS Schedule E-5). Based on historical experience, the price of gas in the twelve months ended September 30, 2006 was an aberration. For the purpose of determining pro forma test year gas charge revenues, the price of gas should be adjusted to reflect a price that is more likely to be representative of prospective conditions.

Q. How should the price of gas used in the calculation of pro forma gas charge revenues be determined?

A. The Companies provided the average prices of gas for the twelve months ended March 31, 2007 in the responses to AG 2.32 (NS) and AG 2.38 (PGL). The average prices for that twelve month period, while still high by historical standards, eliminate much of the effect of the abnormal price spike in the twelve months ended September 30, 2006 and should be more representative of the normal, prospective price of gas. For the twelve months ended March 31, 2007, the NS average price of gas was $8.00 per dekatherm, and the PGL average price of gas was $8.12 per dekatherm. I recommend that these prices be used in calculating the pro forma test year gas charge revenues.

Q. What is the effect of using these prices to calculate pro forma test year gas charge revenues?

A. The effect is to reduce NS pro forma test year gas charge revenues by $40,914,000 and PGL pro forma test year gas charge revenues by $199,254,000 (my Schedule C-1). The cost of gas sold expense is reduced by equal amounts. For NS, the reduction to pro forma gas charge revenues results in a pro forma reduction to uncollectible accounts expense of $286,000. For PGL, the reduction to pro forma gas charge revenues results in a pro forma reduction to uncollectible accounts expense of $5,061,000 (my Schedule C-2).

The Companies are requesting that the portion of uncollectible accounts expense related to the cost of gas be recovered through a separate rider. An adjustment to uncollectible accounts expense to reflect normal gas prices is appropriate whether the Commission approves this rider proposal or not. It is appropriate if the rider is approved in order to establish a proper base against which the actual gas cost related to uncollectible accounts expense will be measured. It is also appropriate if the rider is not approved in order to prevent the Companies from recovering excessive allowances for uncollectible accounts expense in their base rates as a result of basing the pro forma uncollectible accounts expenses on abnormally high gas cost revenues.

2. OPERATION AND MAINTENANCE EXPENSE

Q. How are the pro forma operation and maintenance expenses included in the Companies' revenue requirements determined?

A. The actual operation and maintenance expenses for the test year ended September 30, 2006 are the starting point. Those actual expenses are then adjusted to reflect Commission ratemaking policy, to incorporate the effect of known and measurable changes, and to eliminate any abnormal or non-recurring items. The intent is to include expenses reflecting normal operations in the determination of revenue requirements.

Q. Are you proposing adjustments to the pro forma operation and maintenance expenses included by the Companies in their determination of adjusted operating income under present rates?

A. Yes. I am proposing adjustments to the pro forma operation and maintenance expenses of both Companies. I first address adjustments affecting both companies. I then address one adjustment that affects only NS and two adjustments that affect only PGL.

a. Rate Case Expense

Q. Have the Companies included the amortization of rate case costs in pro forma test year operating expenses?

A. Yes. NS includes $954,000 of rate case expense in pro forma test year operating expenses. PGL includes $1,212,000 of rate case expense in pro forma test year operating expenses. Both of these annual expense levels are based on the Companies' proposal to normalize the estimated costs of the present cases over three years.

Q. In your opinion, is this reasonable?

A. No. The period over which the rate case cost is normalized should reflect a reasonable estimate of the time between rate cases, the intent being to match the cost recovered in rates to the cost incurred. Based on the Companies' recent histories, a normalization period of at least five years would be more reasonable. Both of the Companies' last rate cases were in 1995, approximately twelve years ago. Given this actual experience, I do not believe that it is reasonable to normalize the estimated cost of the present rate case over only three years.

Q. What is the effect of normalizing rate case expenses over five years rather than over three years?

A. The effect is to reduce the NS pro forma test year operation and maintenance expense by $382,000 and the PGL pro forma test year operation and maintenance expense by $485,000 (my Schedule C-2).

b. Medical and Insurance Costs

Q. Have you analyzed the Companies' pro forma adjustments for group insurance costs for active employees?

A. Yes. The pro forma adjustments are based on the forecasts of group insurance costs for fiscal 2007. NS is forecasting group insurance costs of $1,581,000, which represents an increase of 16.0% over the actual cost incurred in the twelve months ended September 30, 2006. PGL is forecasting group insurance costs of $12,696,000, which represents an increase of 14.6% over the actual cost incurred in the twelve months ended September 30, 2006. The adjustments to group insurance are included as part of the "Medical and Insurance costs for Fiscal 2007" adjustments.

Q. In your opinion, are the increases in these costs forecasted by the Companies reasonable?

A. No. For example, NS and PGL Schedules C-11.3 show the group insurance costs by year from 2003 through 2006. The actual increases in group insurance costs in those years were in general significantly lower than the magnitude of the increases forecasted by the Companies in 2007.

Q. Should the pro forma adjustments being proposed by the Companies be modified?

A. Yes. In response to AG Data Request 2.18 (PGL), the Companies provided the actual group insurance costs for the first six months of fiscal 2007. I recommend that the pro forma group insurance expenses be determined by annualizing the actual costs for that six month period.

The actual NS group insurance cost for the first six months of fiscal 2007 was $740,000. The annualized cost is $1,480,000, which is $101,000 less than the fiscal 2007 cost forecasted by NS.

The actual PGL group insurance cost for the first six months of fiscal 2007 was $5,848,000. The annualized cost is $11,696,000, which is $1,002,000 less than the fiscal 2007 cost forecasted by NS.

Those reductions to annual group insurance costs must then be allocated between capital and expense, to recognize that a portion of benefits costs is charged to plant accounts. After making this allocation, the result is a reduction of $83,000 to NS pro forma operation and maintenance expense and a reduction of $866,000 to PGL pro forma operation and maintenance expense (my Schedule C-2.1).

c. Uncollectible Accounts Expense

Q. Have you incorporated adjustments to uncollectible accounts expense into your determination of pro forma test year operating income?

A. Yes. As explained in my testimony on test year revenues, I am proposing to modify pro forma test year gas charge revenues to reflect a lower prospective cost of gas than was incurred in the test year and to adjust the pro forma test year uncollectible accounts expense based on those lower gas charge revenues. In addition, because the GCI parties are opposing the recovery of the uncollectible accounts expense related to gas charge revenues through a separate rider, I am including the entire uncollectible accounts expense in the base rate cost of service. My proposed adjustments to pro forma test year uncollectible accounts expense are shown on my Schedule C-2.

d. Incentive Compensation

Q. What is your understanding of the Commission's general practice with regard to the inclusion of incentive compensation expense in the revenue requirements of regulated utility companies?

A. It is my understanding that the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations. (See, for example, Docket No. 01-0432, Illinois Power Company, Order, March 28, 2002, at pages 42-43; Docket No. 04-0779, Nicor Gas Company, Order, September 20, 2005, at pages 44-46; and Docket Nos. 06-0700, 06-0071, and 06-0072, (consolidated) AmerenCILCO, AmerenCIPS, AmerenIP, Order, November 21, 2006, at page 72.)

Q. Have the Companies provided any testimony in this case demonstrating that its incentive compensation program can reasonably be expected to reduce expenses and create greater efficiencies in operations, thereby producing net benefits for ratepayers?

A. As far as I can determine, the Companies have not presented any such testimony. Therefore, pro forma operation and maintenance should be adjusted in this case to eliminate the incentive compensation incurred in the test year. Elimination of incentive compensation reduces NS pro forma test year expenses by $282,000 and PGL pro forma test year expenses by $2,615,000 (my Schedule C-2). These adjustments include the elimination of incentive compensation charged to NS and PGL by affiliates.

e. Inflation for Non-Payroll Items

Q. Have the Companies proposed adjustments to test year operation and maintenance expense to recognize the effect of inflation from the test year to fiscal 2007?

A. Yes. NS has proposed an inflation adjustment of $542,000 and PGL has proposed an inflation adjustment of $3,084,000.

Q. How did the Companies calculate the proposed inflation adjustments to test year operation and maintenance expense?

A. The Companies began with total test year operation and maintenance expense other than purchased gas expense and then subtracted out expenses that were subject to separate, specific adjustments. The forecasted increase in the Consumer Price Index, 2.40%, was applied to the remainder of expenses, to calculate the expected effect of inflation on the operation and maintenance expenses that were not specifically adjusted.

Q. Are the Companies' proposed inflation adjustments appropriate?

A. No. It is my understanding that Part 285.150(e) of the Commission's rules governing pro forma adjustments for known and measurable changes specifically states that "Attrition or inflation factors shall not substitute for a particularized study of individual capital, revenue or expense components." The Companies' proposed inflation adjustments clearly entail the application of an inflation factor and are not based on a particularized study of expense components of the Companies' revenue requirement. Therefore the inflation adjustments do not comport with the Commission's rules on pro forma adjustments, as I understand them.

Q. Have the Companies attempted to explain this apparent inconsistency between the proposed inflation adjustments and the Commission's rules governing pro forma adjustments?

A. Yes. In response to Staff Data Request BAP 2.01, NS and PGL stated that they "did not apply an inflation factor to substitute for a particularized study of individual revenue or expense components. The other proposed adjustments are based on a particularized study of individual revenue and/or expense components. This adjustment then inflates the remaining components based on a reasonable forecast of inflation." Thus, it appears to be the position of the Companies that because other elements of operation and maintenance expense were subject to particular, specific adjustments for known and measurable adjustments, the inflation adjustment did not substitute for those other adjustments, but rather supplemented those other adjustments.

Q. Is this explanation reasonable?

A. No. The Companies' inflation adjustments inappropriately substitute for a particularized study of individual capital, revenue or expense components in the sense that the adjustments are applied across a broad assortment of different expenses rather than adjusting individual items of expense for specific changes that are known to affect that expense. For example, one of the categories of costs not specifically studied and adjusted is the expense of outside professional services. Those expenses have not varied with inflation in recent years, and the Companies have not provided any evidence that those expenses will vary with inflation prospectively.

I do not believe that just because certain proposed adjustments were based on particularized studies the Companies can justify application of a general inflation factor to the remainder of the individual expense components. The Companies have not shown that their inflation factor, the Consumer Price Index, has any relevance to expenses to which it is applied. The application of the Consumer Price Index is an improper substitute for specific adjustments based on known and measurable changes. I do not believe that Part 285.150(e) can reasonably be interpreted to authorize such inflation adjustments, the fact that other adjustments were based on particularized studies notwithstanding.

Q. Is the application of an inflation allowance an adjustment for a known and measurable change?

A. No. It is a generalized adjustment applied to a broad assortment of expenses. Some of those expenses may increase with inflation, some may not. Some of the expenses may decrease. Whatever the inflation adjustment is, it is not an adjustment for a known and measurable change. Therefore, the inflation adjustments should be eliminated from pro forma test year operation and maintenance expenses. Elimination of these adjustments reduces NS pro forma expenses by $542,000 and PGL pro forma expenses by $3,084,000 (my Schedule C-2).

f. Lobbying

Q. Have the Companies included lobbying expenses in test year operation and maintenance expense?

A. Yes. NS test year operation and maintenance expense includes $19,000 of lobbying expenses, and PGL test year operation and maintenance expense includes $132,000 of lobbying expenses. These expenses should be eliminated from the cost of service, and I have done so on my Schedule C-2. It is my understanding that the Companies agree that these expenses should be eliminated.

g. Franchise Requirements

Q. What expense did NS incur for franchise requirements in the twelve months ended September 30, 2006?

A. The franchise requirements expense represents the value of gas provided to municipalities under franchise agreements. The NS franchise requirements expense in fiscal 2006 was $2,041,000.

Q. How does this compare to the level of that expense incurred in other recent years?

A. It is significantly higher. For the three years 2003 – 2005, the average expense was approximately $1.2 million. The highest expense in that three year period was $1,432,000.

Q. Why was the expense so much higher in 2006?

A. As explained in the response to AG Data Request 2.36 (NS), the main reason for the higher expense was higher gas charge rates in fiscal 2006.

Q. Should the franchise requirements expense included in pro forma test year operating expenses be adjusted?

A. Yes. As I explained in my testimony on gas charge revenues above, the price of gas in fiscal 2006 was abnormally high. Accordingly, the franchise requirements expense should be adjusted to reflect a more normal level of gas charge rates.

Q. Have you calculated an adjustment to franchise requirements expense to reflect a more normal level of gas charge rates?

A. Yes. Based on the response to AG Data Request 2.36 (NS), the franchise requirements expense incurred in fiscal 2006 consisted of 176,344 dekatherms at an average rate of $11.572 per dekatherm. As I stated in my testimony on gas charge revenues, the average price of gas for the twelve months ended March 31, 2007 eliminates much of the effect of the abnormal price spike in the twelve months ended September 30, 2006 and should be more representative of the normal, prospective price of gas. Using the price of $8.00 per dekatherm for that twelve month period, the franchise requirements expense would be $1,411,000 (Schedule C-2). This is $630,000 less than the expense incurred in twelve months ended September 30, 2006. Therefore, I recommend that the NS pro forma franchise requirements expense be reduced by $630,000.

h. Compressor Station Fuel

Q. What expense did PGL incur for compressor station fuel and power in the twelve months ended September 30, 2006?

A. This expense represents the cost of fuel used for the operation of underground storage compressor stations. The PGL compressor station fuel and power expense in fiscal 2006 was $4,985,000.

Q. How does this compare to the level of that expense incurred in other recent years?

A. It is significantly higher. For the three years 2003 – 2005, the average expense was approximately $2.8 million. The highest expense in that three year period was $3,398,000.

Q. Why was the expense so much higher in 2006?

A. As explained in Peoples Gas Exhibit LK-1.0, pages 12-13, compressor fuel expense reflects the price of gas and the volume of gas used. The higher expense in 2006 is mainly the result of the higher gas costs in 2006, which I have described in my testimony on test year gas charge revenues, above.

Q. Should the compressor station fuel cost included in pro forma test year operation and maintenance expense be adjusted?

A. Yes. The compressor station fuel cost should reflect a more normal level of gas costs than the expense that was incurred in the twelve months ended September 30, 2006. The increase in expense from fiscal 2005 to 2006 was $1,587,000 (PGL Schedule C-4), with the reason for this increase being attributed mainly to the increase in the cost of gas in 2006 (Peoples Gas Exhibit LK-1.0, page 13). I recommend that the increase in expense from 2005 to 2006 be eliminated and that the pro forma compressor station fuel and power expense be set at $3,398,000. This represents a reduction of $1,578,000 from the actual fiscal 2006 expense (my Schedule C-2). I would note that even after my proposed adjustment, the pro forma expense is somewhat in excess of the four year average expense for the years 2003 – 2006, even with the abnormally high gas costs in 2006 included in that average.

i. Major Maintenance Expense

Q. Did PGL incur expenses related to a major maintenance project in the twelve months ended September 30, 2006?

A. Yes. As shown on its Schedule C-15, PGL incurred $546,000 of expense related to the repair of a damaged compressor crankshaft as a result of a bearing failure.

Q. Does PGL incur such expenses on a normal basis?

A. No. PGL Schedule C-15 shows the costs for major maintenance projects in the years 2003 – 2006. There were no other major maintenance projects in this four year period.

Q. Should the major maintenance expense incurred in fiscal 2006 be adjusted?

A. Yes. The expense should be adjusted to recognize that PGL does not incur expenses for major maintenance projects on an annually recurring basis. Given that no other major maintenance expense was incurred in the four year period 2003 – 2006, I believe that it would be reasonable to normalize this expense over a period of at least four years. Normalization of the major maintenance projects over four years reduces this expense by $410,000 (my Schedule C-2).

3. DEPRECIATION EXPENSE

Q. Are you proposing any adjustments to pro forma test year depreciation expense?

A. Yes. I have proposed to modify the balance of utility plant included in rate base. The pro forma depreciation expense is based on the pro forma balance of plant in service. Therefore, the depreciation expense included in the cost of service should be modified to reflect the adjustment to plant in service. On my Schedule C-3, I have calculated an adjustment to reduce the NS depreciation expense by $22,000 and the PGL depreciation expense by $423,000.

4. TAXES OTHER THAN INCOME TAXES

Q. Are you reflecting any adjustments to taxes other than income taxes in your calculation of pro forma operating income?

A. Yes. I have proposed a reduction to wage and salaries to eliminate incentive compensation from pro forma test year operating expenses. Consistent with that adjustment, I am also eliminating the payroll taxes on those wages and salaries. The adjustment to taxes other than income taxes is shown on my Schedule C-4. In addition to this derivative adjustment, I am also proposing to modify the pro forma invested capital tax expense included in the Companies' revenue requirement.

Q. Why are you proposing to modify the pro forma invested capital tax expense?

A. The Companies have adjusted the invested capital tax to recognize the increased operating income that will result from the increased rates that they are proposing in these cases, the theory being that an increase in operating income will in turn result in an increase to retained earnings and total capitalization, which is the base for the invested capital tax (Peoples Gas Exhibit SF-1.0, pages 24-25). This pro forma adjustment is inappropriate and should be eliminated.

Q. Why should the pro forma adjustment to invested capital tax be eliminated?

A. For two reasons. First, the Companies have both assumed, for the purpose of this adjustment, that their entire rate increase requests would be approved by the

Commission. Based on my experience, in Illinois as well as other jurisdictions, such an outcome is highly unlikely. Second, I do not believe that the Companies have established with any reasonable degree of certainty that an increase to operating income will lead to an equal increase to retained earnings and capitalization. For example, it is entirely possible that an increase to operating income would lead to an increase in dividends. To the extent that any additional earnings are paid out in dividends, there will be no increase to retained earnings as a result of the increase in operating income.

Q. What is the effect of eliminating the increase to the invested capital tax associated with the proposed rate increases?

A. The effect is to reduce NS pro forma taxes other than income taxes by $50,000 and PGL pro forma taxes other than income taxes by $814,000 (my Schedule C-4). My adjustment to the Companies' pro forma expenses reflects the elimination of the adjustments as originally proposed by the Companies rather than the amounts in the subsequent PS and NGL "Errata" filings. I have eliminated the original adjustments because those are the amounts included in the Companies' pro forma statements of operating income used as the starting points in my analyses.

5. INCOME TAX EXPENSE

Q. Please explain your adjustment to income tax expense.

A. The calculation of my adjustment to income tax expense is shown on my Schedule C-5. This schedule shows the adjustments to taxable income from the other adjustments to operating income that I am proposing. I also calculate the adjustment to interest expense (the weighted cost of debt times rate base) resulting from my proposed adjustments to rate base and the capital structure and cost of debt proposed by Mr. Thomas. I apply the state income tax rate to the adjustments to taxable income to calculate the adjustment to state income tax expense, and apply the federal income tax rate to the adjustments to taxable income net of state income taxes to calculate the adjustment to federal income tax expense.

Q. Does this conclude your direct testimony?

A. Yes.